The small landed estate – tax advantages (and pitfalls)

With anxiety surrounding the stock market upheavals, commercial property concerns and low rates of interest, many investors are looking to the farm or landed estate as a potential area to divert funds for safety, possibly enjoy lifestyle advantages and achieve tax efficiency.

It appears whilst the price of development land has crashed in the last 18 months the value of pure farmland has stayed strong. Perhaps a land agent can predict returns and future land values, but what of the tax advantages and possible pitfalls?

Why is the purchase of the farm such an attractive proposition? Is it the tax advantages or the lifestyle enjoyment or the rural sporting benefits such as shooting? Let us look at the tax advantages with a realistic consideration for recent "attacks" by the Tax Office (HMRC) on not just the farmhouse but also the traditional "mixed estate" with regards to trying to deny Inheritance Tax relief.

"The Lifestyler"

There are many who consider that the "lifestyle farmer" was an invention of the "60s" – wild parties down on the farm with no neighbours to interrupt the fun. The fact that it was in the 60s that the well-known and well understood tax legislation of "hobby farming" was introduced would support this idea. However, lifestyle farmers are a creation which spans centuries of history and tradition. The sole aim of farm land ownership has not always been commercial return.

A clear example of history repeating itself is the Industrial Revolution and the purchase of landed estates from the vast wealth that the factories created. While the purpose behind the acquisition might have been driven more by status than lifestyle and tax planning, there are many parallels that can be drawn from that period of history to current times.

However, anybody contemplating undertaking the purchase of a country estate or following in the steps of the television comedy *The Good Life* must embrace the hobby farming rules with eyes wide open. With the move to diversification, it is also necessary to look at standard commerciality guidelines that must be adhered to in order to achieve the tax reliefs.

So what are the tax reliefs currently available to the lifestyler that make the acquisition of a landed estate (of varying sizes) considered to be so tax driven?

A summary of the potential tax advantages are set out below:

- The ability to rollover gains from business assets into other business assets.
- The potential for entrepreneur's relief for capital gains tax.
- The possibility to 'holdover' capital gains on business assets.
- Business and agricultural property relief for inheritance tax.
- The possibility to claim income tax relief against other income where losses are sustained.
- The ability to repair and improve the property while claiming maximum allowable input VAT and where possible maximum income tax relief.

All reliefs must be carefully scrutinised, and it is essential that all the relevant conditions are met so as to take full advantage of the tax benefits.

As with any business, all the expenses claimed must be wholly and exclusively incurred for the purpose of the farming trade or estate enterprise, and the operation must be commercial and must be shown to be commercial.

Income Tax Advantages

The industry of farming as opposed to pure landowning has historically been a 24 hours a day, seven days a week vocation, and so a number of expenses which might in other industries be seen as private expenditure have for a large number of years justifiably achieved acceptance as a business expense. Examples of these costs are:

- Farmhouse expenses;
- The cost of vermin control;
- The cost of four-wheel drive vehicles to achieve farm inspections, etc and
- Repairs to cottages occupied by family members living on the farm and working on the farm.

The key issue of vermin control ties into the fairly recent attacks on shooting by HM Revenue & Customs (HMRC).

Farm trading tax losses can be offset against total income in the year of the loss provided conditions are met, e.g. there is a profit every sixth year on the farm as set out by the "hobby farming" rules. The reality is that tax refunds generally at a 40% (and rising!) rate of income can possibly help support what is deemed to be the "lifestyle" farming operation.

HMRC have been quite rigorous in their pursuit of ensuring that the "hobby farming rules" are applied correctly and catching out a number of non profitable farmers and unaware tax advisers. The tax rules can be very complex and many urban tax advisers have come "unstuck" in the HMRC rigid application. However, the tax rules around hobby farming are very sympathetic to UK agricultural and farming issues provided that they are understood and treated with respect.

Inheritance Tax

It comes as a surprise to many tax advisers who are possibly not farm practitioners that the inheritance tax reliefs for the landed estate are so potentially favourable.

In theory the whole of the landed estate including the farmhouse is capable of achieving 100 per cent inheritance tax relief – s.115 IHTA 1984 refers to such farmhouses in the same sentence as land, cottages and buildings as character appropriate. The reality is that HMRC are currently finding lots of weaknesses in the inheritance tax claims submitted following probate.

The key point to note is that the first inheritance tax relief to be claimed is Agricultural Property Relief (APR). There have been a number of attacks by HMRC on the two areas of weakness of APR – agricultural value and the need for Business Property Relief (BPR) – the second inheritance tax relief - to support any failings in a claim for APR.

Let's start at the common areas of HMRC attack – agricultural value and the farmhouse.

The Farmhouse

The most recent significant case on a farmhouse has been *Arnander* (Arnander (executors of McKenna, decd) v Revenue and Customs Commissioners, 2006). The Special Commissioner (Dr Brice) looked at five tests:

i. Is the farmhouse appropriate in size, content and layout with the farm buildings and the area of farmland being farmed, i.e. "character appropriate"?
ii. Is the farmhouse proportionate in size and nature to the requirements of the farming activities being conducted?
iii. Would anyone know the building as a farmhouse when one sees it, although it might be difficult to describe (the 'elephant test')?
iv. Would the 'educated rural layman' regard the property as a farm with a house, rather than a house with farmland attached?
v. Is there an historical association between the farmhouse and the agricultural property that is connected with it?

There have been many jokes about an "educated rural elephant" and the farmhouse but the tests are relatively straightforward to understand and are regularly applied by HMRC.

Agricultural Value

Various tax cases have highlighted HMRC trying to attack the claim for 100% inheritance tax relief on the farmhouse, for example *Starke* and *Higginson*. *Antrobus 1* was considered a relative success for the continued support of the claim for 100% inheritance tax relief on the farmhouse.

However, *Antrobus 2* meant that the Land Tribunal would be involved in determining the "agricultural value" of the farmhouse. Essentially having won the argument for inheritance tax relief on the farmhouse, e.g. character appropriate, history, geography etc, there has been an attack on value, insisting that a lower agricultural value is used.

Agricultural value applies as if there was a perpetual covenant for the property to be used for agricultural purposes. In *Antrobus 2* the market value was reduced by 30% to allow for the restriction of agricultural value. There are many who think this is the guideline, however each case should be judged on its own merits.

The reality of inheritance tax relief for farmhouses is that many land agents accept 70% of market value (i.e. a reduction of 30%) as a starting point for negotiation.

Development Land

Many investors purchase a farm for potential development value and try and ensure that the "cloak" of tax planning advantages are achieved.

As discussed in the July issue, development land is a very obvious example of the difference between APR and BPR.

At the date of death the difference between the agricultural value of land and the market value is the "hope" value (see below). Clearly the development value (hope value) would not be covered by APR because of the agricultural value restriction, so there is a need for BPR to secure valuable inheritance tax reliefs on potential development land.

Many investors in a farm or landed estate might deliberately look towards an agricultural property with development potential and that could be short, medium or long term potential to help support the children and grandchildren. Problems can arise from potential inheritance tax if death of the owner occurs before development is achieved. Ironically in practice some of the farms in the least picturesque or desirable locations have the greatest potential.

Valuing hope

As mentioned, at the date of death the 'hope value' of land has to be valued and will be subject to inheritance tax like any other asset in the estate of the deceased.

Prior to the current credit crunch it was argued that all land had some 'hope value', but what now with the crash of development land values? There are those who say paying tax on hope value is like paying tax on air.

How is hope value ascertained in reality? It must be valued at market value under s.160 IHTA 1984. The land agent acting for the deceased has to apply the 'Red Book' in accordance with his or her Royal Institute of Chartered Surveyors qualification. Concerns and caveats must be documented and, if necessary, a range of values presented. The estate cannot be finalised until the value and the resulting inheritance tax liability is agreed.

Careful planning must be in place around any farm or estate that involves potential development land.

How does the Investor secure BPR as well as APR on the farm?

Perhaps the answer is in the title – a business! BPR applies where there is a business and IHTA 1984 s.105 (3) tries to deny relief where there is an investment business as opposed to a trading business.

"The Earl of Balfour" – not an investment business

There has been a very recent tax case, *The Earl of Balfour*, where there was a success for the taxpayer - BPR was allowed on a mixed estate.

The First Tier Tax Tribunal (formerly the Special Commissioners) was asked to rule on the question of whether inheritance tax BPR was available for a mixed agricultural estate in Scotland. The taxpayers succeeded in rejecting HMRC's argument that relief should be refused on the ground that the business in question was "*...wholly or mainly the making or holding of investments*" (the 'investment business' exclusion that applies for BPR under IHTA 1984 s 105(3)).

The more general aspects of this case were discussed in the August issue, but the case is also very encouraging for the investor who wants to genuinely run a business whilst enjoying all the pleasures of the mixed estate.

Diversification & Let Property - ability to achieve BPR for inheritance tax

The traditional large farm and/or landed estate does generally include a lot of diversification away from farming, including let property above all. Can this achieve BPR relief from inheritance tax?

On the question of whether the single business was an 'investment business', the Tribunal in the *Earl of Balfour* held that it was necessary to establish where the preponderance of the activity was. There would be a variety of relevant factors including turnover, profit, expenditure and time spent by everyone in various activities. The Tribunal suggested that, in most cases, it would probably not be possible to produce records under which a precise assessment could be made and that, ultimately, the matter would have to be assessed on the evidence that the parties were able to provide. It would be a matter of general assessment and impression and looking at the activities 'in the round' (using the expression emphasised by the Court of Appeal in the case of *George*). The Tribunal concluded that the business was not wholly or mainly the making or holding of investments, and hence BPR was available.

It must be remembered that this case is being appealed by HMRC and it was an inherited estate where the owner was totally controlling. Will the relatively newly acquired estate be able to achieve such evidence of involvement? I quote paragraph 42 from the judgement:

> *"My impression is that the management of a landed estate such as Whittingehame Estate even where a significant amount of the income is letting income is, overall, mainly a trading activity. That is where the preponderance of activity and effort lies...most estates of the type under discussion are heavily based on farming and to some extent on forestry and woodland management and related shooting interests. The letting side was ancillary to the farming, forestry, woodland and sporting activities. The farming activities, albeit they include agricultural tenancies, occupied by far the greater area of the Estate..."*

This would be a huge inheritance tax advantage to investors of a mix of a real business and let property.

Capital Gains Tax (CGT)

Many investors have bought farms to asset strip (see below) and to make huge (or even just good) gains on disposals of the land. Under the 10% rate of CGT previously available for business assets this was even more attractive, but even the standard rate of CGT of 18% that currently exists can still be seen as beneficial.

The 10% rate of CGT can still be achieved from 6th April 2008 through Entrepreneur's Relief. However there is a £1million lifetime 'cap' on Entrepreneur's Relief.

Entrepreneur's Relief is available where there has been a 'qualifying business disposal', which occurs where there is a material disposal of business assets.

The material disposal, i.e. the disposal of the whole or part of a business reintroduces a subject matter frequently litigated upon under the old retirement relief rules. HMRC have indicated that they will apply the same retirement relief principles to ER with regard to disposals of substance.

It would appear that the potential and future gains on development land might push taxpayers and tax planning towards increased use of rollover relief and holdover relief for CGT planning moving forward. This can involve complications, e.g. the whole proceeds should be rolled over in full.

The Farming "Asset-Stripper"

There are many farms and estates that have been purchased with the aim of securing capital gains either through the subsequent sale or from selling off elements of the farm. What is the tax position?

As mentioned, from 6th April 2008 the taxpayer can no longer claim Business Asset Taper Relief on capital gains and achieve the 10% rate of CGT. Instead, the flat 18% rate applies to all gains. However Entrepreneurs' Relief is available, which allows the effective 10%

rate of tax for £1 million of lifetime gains on business disposals. But is Entrepreneurs' Relief all it seems?

There is a quirk of the Entrepreneurs' Relief legislation in that in order to qualify for ER, there must be a disposal of the whole or part of the trading business; the sale of an asset in isolation will not qualify for the relief.

The criteria are the same as those relating to the old retirement relief, and are discussed in capital gains manual at CG 63530 onwards and will be applied for this purpose:

> *"If some business activities continue after the disposal you need to identify all the activities relating to a particular part of the business. For relief to be due the whole of those activities must cease when the relevant asset or assets are disposed of. By contrast, if an asset or assets have been sold but no particular activity or set of activities disappeared with the asset disposal, it cannot be said that any part of the business has been disposed of."*
>
> ***HMRC Manuals, CG 63530***

This effectively reintroduces the 'mere asset' point of retirement relief.

There are many who argue that the effective "loss" of the 10% rate of CGT and the move to 18% will dishearten the potential farm investor but this doesn't seem the case as the other tax reliefs seem so attractive.

Complex Interaction of Capital Gains Tax and Inheritance Tax

There are arguments to say that the beneficiary of the development land on the death of the landowner would like as high a value as possible as this will be the capital gains tax (CGT) base cost for any future disposal. Obviously the executors would only want to endure a high hope value if the land achieves inheritance tax reliefs, e.g. business property relief (BPR) on farmland.

VAT

There is large scope to correctly claim input VAT on repair, improvement and general maintenance to the farming and other diversified activities, which can be of significant advantage to the investor or lifestyler.

Historically the farm VAT Return has been very straightforward, with agricultural supplies at zero rate and the claim of full input VAT at the standard rate. But there have been changes in recent years making this more complicated, for example the question of rent received on residential cottages and the review as to partial exemption, or the disallowance of certain elements of input VAT such as private usage of the farm shoot etc. Most diversified activities have to charge output VAT at the standard rate.

The new lifestyle farmer tends to have high standards of quality of environment and the improvements and repairs can be very extensive, including repairs to the farmhouse. The claim for input VAT can therefore be very high and it is essential that claims can be substantiated by such basic guidelines as commerciality, good documentation and high quality bookkeeping. However, there is no doubt that this is a very attractive proposition for the investor/farmer.

Heritage Property

The purchase of a farm or landed estate can link to heritage property reliefs as a method of passing property to heirs without the payment of inheritance tax.

The following are eligible:

1. Land, which, in the opinion of the Board, is of outstanding scenic or scientific interest.
2. Any building for the preservation of which special steps should, in the opinion of the Board, be taken by reason of its outstanding historic or architectural interest.
3. Any area of land, which, in the opinion of the Board, is essential for the protection of the character and amenities of such as a building.
4. Any object which, in the opinion of the Board, is historically associated with such a building.

It is worth considering whether any of these tax advantages could be used when APR or BPR fails.

Summary

The purchase of a farm or landed estate as both a trading investment, a passion and a lifestyle choice contains a complex mix of subjective and objective decision making criteria.

Whilst farming profits have recently improved and rents received can represent a good return, there is scope to lose money. This loss of return can be controlled via a "contract farming" agreement but this also has tax concerns.

Whatever the deciding factors are for the business investor, there is no doubt that the potential tax advantages are very attractive.

As explained, there is scope to obtain income tax reliefs on expenditure, VAT refunds, disposals at a low rate of CGT, to escape inheritance tax on substantial amounts of wealth - AND to avoid noisy, irritating neighbours. How attractive is that? Clearly a subjective choice and in need of close objective analytical review. Location, location, location and great tax breaks. □

Julie Butler F.C.A.

Julie Butler F.C.A. is the author of Tax Planning for Farm and Land Diversification ISBN: 0754517691 (1st edition) and ISBN: 0754522180 (2nd edition) and Equine Tax Planning ISBN: 0406966540. The third edition of Tax Planning For Farm and Land Diversification will be published shortly.
Butler & Co, Bowland House, West Street, Alresford, Hampshire, SO24 9AT
01962 735544
j.butler@butler-co.co.uk
www.butler-co.co.uk